...on the
Future of the
Canadian Financial
Services Sector

The Canadian Venture Capital Industry

Sources of Capital and Implications for Industry Structure

by
Macdonald & Associates Limited

September 1998

Research Paper Prepared for the Task Force on the Future of the Canadian Financial Services Sector

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The views expressed in these research papers are those of the authors and do not necessarily reflect the views of the Task Force on the Future of the Canadian Financial Services Sector

Cat No.: BT22-61/3-1998E-18
ISBN 0-662-27157-2

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Introduction

This report has been prepared in response to a request from the Task Force on Financial Services. It is intended to provide some context on the sources of venture capital in Canada over the past several years, and on how these sources have affected the structure of the venture capital industry and its investment patterns.

To this end, trends in new capital commitments to the venture industry by source and by type of fund for the period from 1991 through 1997 are documented in the following sections of this report as are investment patterns demonstrated by different types of venture funds for this same period.

Context on Industry Structure

Unlike the US and Europe, where almost all venture funds are institutionally-backed limited partnerships with professional venture capital managers, the market in Canada is comprised of several different types of venture capital funds. Particularly since the relative positioning of these different funds has shifted considerably over the past decade, the market here is somewhat complex to analyse from a public policy perspective. It is therefore useful at the outset to have an understanding of the different types of players and where and how they position themselves in the market.

Private independent venture funds were formerly the mainstay of the industry and they continue to be by far the dominant players in the US market. These funds are typically managed by a team of professional venture capital managers who go out and raise a predetermined amount of capital (typically $40 million to $200 million in Canada) from a variety of sources, primarily pension funds, insurance companies and sometimes corporate investors. These funds are generally structured as limited partnerships with a life of 10 years. The venture managers tend to invest the capital they raise in new deals over the first 3 or 4 years of the fund's life, keeping perhaps 30% of the capital in reserve for follow-on financings in these investee companies. Rapidly growing technology companies in particular typically require several rounds of financing over the life of the investment, often totaling in excess of $10 million (or $20 million in the case of biotechnology firms) before being ready to "go public", so the ability to keep capital in reserve for follow-ons is critical. The managers of these funds will return to the market to raise a new pool of capital after 3 or 4 years, conditions permitting, and continue the cycle.

Labour sponsored venture capital funds (LSVCCs), which are unique to Canada, were first introduced in Quebec in the early 1980s with the establishment of the Fonds de Solidarité de Travailleurs de Québec (Solidarité). The provincial government introduced legislation which allowed Solidarité to sell units in its Fund to small retail investors who would receive a 20% provincial tax credit on any investment up to $3,500. In return, the fund would invest the majority of its assets in equity investments in small and mid-sized businesses which satisfied established criteria. The federal government subsequently agreed to provide a matching 20% tax credit to investors in the fund. In the late 1980s, the federal government introduced legislation which allowed for the creation of nationally chartered labour sponsored venture capital funds and

Working Ventures was established shortly thereafter, moving quickly to secure matching tax credits from Saskatchewan. In 1992, several other provinces introduced legislation to provide matching tax credits, resulting in the creation of the Working Opportunity Fund in BC, the Crocus Fund in Manitoba, some 18 individual LSVCCs in Ontario, and a national focus for Working Ventures.

The regulatory environment differs between provinces for the labour funds with some implications for investment patterns. In Quebec, for example, shareholders must generally hold their units (or repay their tax credits) until age 65. Until recently, units sold in Ontario had to be held for only 5 years before they could be redeemed without penalty, with obvious implications for investment strategies and liquidity requirements.

Corporate Funds are wholly owned subsidiaries or operating divisions of financial or industrial corporations. Several of the bank groups have a long history in the venture capital industry, particularly the Royal Bank (Royal Bank Capital Corp), and TD (TD Capital). With its acquisition of Montreal Trust, BNS acquired Roynat, which also has a long history in the venture industry. BMO and CIBC are more recent entrants to the venture arena (although CIBC has been very strong in larger private equity transactions). A number of other corporate players like BCE and Bell and other financial institutions like the Caisse de Depot have formal venture capital operations that are active in the market. The "bank groups" with venture capital activity captured in our database include Royal Bank Capital Corp, TD Capital, Roynat, Investissement Desjardins, LBC Capital (Laurentian Bank), HSBC Capital (HongKong Bank) and CIBC Innovation Fund. The Bank of Montreal has contracted out its venture activity to Ventures West, so while BMO is the source of the capital, the investing is actually done by a private independent fund.

Government Funds today are limited to the Venture Capital Division of the Business Development Bank and a handful of funds in Quebec (like Innovatech) which were established primarily to help finance young technology companies.

Hybrid Funds are venture groups that have secured at least 50% of their capital from government or funds with government incentives (labour sponsored funds) or as a direct result of government policy (immigrant investor funds that operate as venture capital funds).

For each of these investor types and for the industry as a whole, there are three key areas of activity that are relevant to the analysis.

Capital under management represents total aggregate resources being managed by a group of investors or by the industry as a whole. This indicator has traditionally been used as a proxy for industry size and includes the total amount being managed by these funds, regardless of how much is still liquid and available to be invested. As the labour sponsored venture funds have grown in prominence in the industry, the amount of capital under management somewhat overstates the industry's resources since these funds are required to invest only a portion of their capital (60% to 80% depending on the jurisdiction) in venture capital situations.

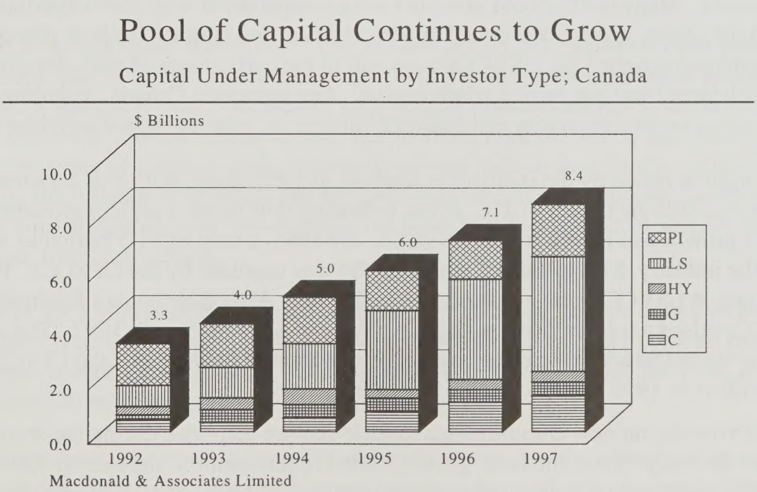
Liquidity represents the actual amount of capital that is free and available for investment in venture situations in the future. Liquidity is calculated by subtracting both the amount of capital invested in a given year and the amount returned to investors that year from the amount of liquid capital at the beginning of the year and then adding the total amount of new capital raised that year. A comparison of the amount of liquid capital in the industry at a point in time with recent investment trends provides an indication of how well placed the industry is to continue to invest at current rates.

Investment activity (disbursements) reflect the amount of venture investment activity in a given year. This activity is typically tracked in terms of total amount invested and the number of deals (financings) done and can be analysed by region, by industry sector, by stage of development of investee companies, by transaction size or by other key variables.

Structure of the Canadian Industry

The pool of capital being managed by the Canadian venture capital industry has been growing rapidly in recent years, reaching $8.4 billion by the beginning of 1998[1]. As Chart 1 shows, much of this growth has been driven by the growth in LSVCCs, which at the beginning of this year were collectively managing $4.2 billion or half of the industry's resources. The private independent funds, which were the dominant type of fund in the 1980s, now account for slightly less than one quarter of the industry's resources and corporate funds (including bank groups) account for 16% of the pool.

Chart 1



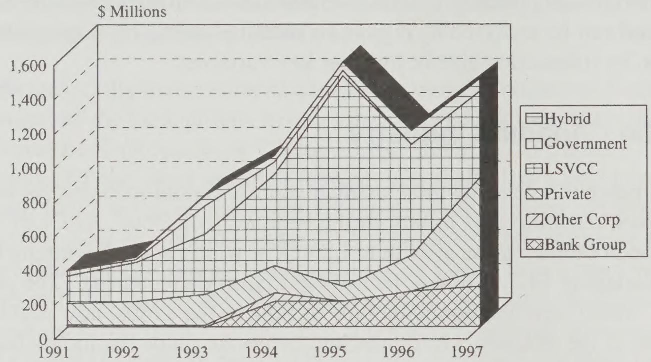
[1] The amount of capital under management and new capital raised is to December 31st for all funds except LSVCCs which are measured from March 1st to February 28th to take account of the RRSP season

The composition of the industry is clearly determined by the amount of capital raised by different types of venture funds over time. As Chart 2 illustrates, there have been some significant shifts between fund types in recent years.

Chart 2

Capital Commitments Shift Between Different Fund Groups

New Capital Commitments by Fund Type; Canada



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New capital commitments to Canadian venture funds were modest at best in the early 1990s for a variety of reasons. Many institutional investors were disappointed with their experience with this asset class in the 1980s, primarily because of performance, and stopped backing private funds, as did their counterparts in the US. LSVCCs were still in the early stages of their development (except for Solidarité) and not raising much capital. And corporate Canada, including the banks, was coping with a serious recession and had little interest in venture capital activities at the time.

Of the $329 million raised by the industry as a whole in 1991, about 40% was captured by the private funds and 40% by the LSVCCs. In the following four years, a rapidly growing share of the industry's growth was driven by the LSVCCs. By 1995, a total of $1.5 billion of new capital flowed into the industry, $1.2 billion of which (80%) was captured by the LSVCCs. However, investor interest in LSVCCs now appears to be in decline. After their banner fundraising year in 1995, LSVCCs raised a total of $647 million in 1996 and $504 million in 1997. The situation is particularly acute in Ontario, where the amount of new capital flowing into the LSVCCs declined from $625 million in 1995 to $125 million last year.

After making virtually no new commitments to their venture activities during the second half of the 1980s and the early 1990s, the bank groups started to recommit to the area in 1994. By the end of 1997, the bank groups had together committed an additional $740 million to their venture capital operations, which accounted for about 15% of all new capital flowing into all types of funds over this period. Government and hybrid funds play a modest role in the industry and have not accounted for a significant share of new capital being raised by the industry in recent years.

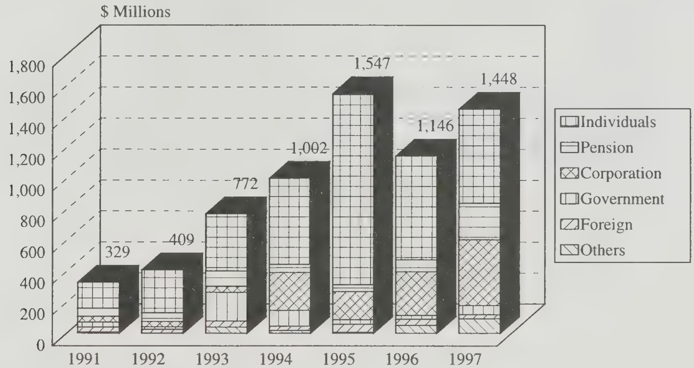
Where is the Capital Coming From?

As one might expect, given the growing prominence of the LSVCCs, the lion's share of new capital coming into the venture industry in recent years has come from individuals, as highlighted in Chart 3 below. At their peak in 1995, LSVCCs in Canada raised more than

Chart 3

Supply Dependent on Individual and Corporate Investors

New Capital Commitments by Source; Canada



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$1.2 billion from individual Canadians. The reduced tax credits introduced that year, coupled with a reduced maximum investment (from $5000 to $3500) and a lengthened minimum holding period (from 5 years to 8 years) resulted in significantly reduced interest in these funds among investors. However, it is interesting to note that in 1997, high net worth individuals started to invest in other types of venture funds (primarily private independent funds). XDL Capital (managed by the founder of Delrina) and McLean Watson (managed by two former senior executives from SoftImage) are two examples of funds that have attracted significant commitments from individuals.

In addition to the $740 million they committed to their in-house venture activities between 1994 and 1997, the banks committed a further $150 million over this period to private independent venture funds, bringing their total capital commitment to venture capital activities over the past four years to $900 million.

While pension funds, insurance companies and endowments are the primary sources of capital for venture funds in the US, these institutional investors have effectively removed themselves from the venture market in Canada for the past 10 years (see Chart 4), as previously noted. After collectively committing $185 million and $176 million to Canadian venture funds in 1987 and 1988 respectively, pension funds sharply reduced their commitments to as low as $20 million in

1990 and have kept them at a nominal level until last year. There were only one or two pension funds that made any significant capital commitments during this period.

In our view, the initial sharp decline in pension fund commitments was largely in response to cyclical factors. Performance data was starting to suggest that funds formed in the 1983-1986 period were not performing well and institutional investors stopped supporting new funds. A similar pattern was evident in the US where pension fund commitments fell sharply in the late 1980s and stayed depressed until about 1992. However, while the private independent funds in the US started to regain favour with institutional investors in 1992, their Canadian counterparts were unable to rekindle institutional interest. A number of structural impediments (small market size and limited number of experienced fund managers) made it difficult for many of these funds to make new commitments, particularly since they were still working through some of the poorer investments they had made in the mid 1980s.

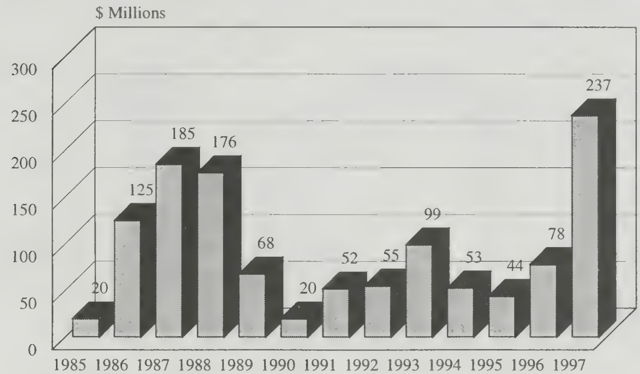
Furthermore, many institutional investors did (and still do) believe that there were simply not enough attractive opportunities in the Canadian market to justify their return to the venture capital arena, despite the dramatic changes in the economy and the shifts towards new sources of wealth creation. The net result was that private independent venture funds raised less than $200 million per year from all sources until 1996, when they surpassed that barrier (by a thread) for the first time in 10 years, raising $211 million. It appears that institutional attitudes may be starting to change since the private funds raised a total of $542 million last year, which represented 37% of all new capital coming into the industry.

Although the $237 million of new capital commitments made by pension funds last year set a new record, this does not necessarily suggest the beginning of an upward trend. Even with a change in attitude, market size will continue to be an issue. While very large pension funds in the US can comfortably commit 2%-3% of their assets to venture capital and buyout funds, the same is clearly more difficult to do in the smaller Canadian market.

Chart 4

Pension Funds Leave the Market for a Decade

Pension Fund Commitments to VC Managers; Canada



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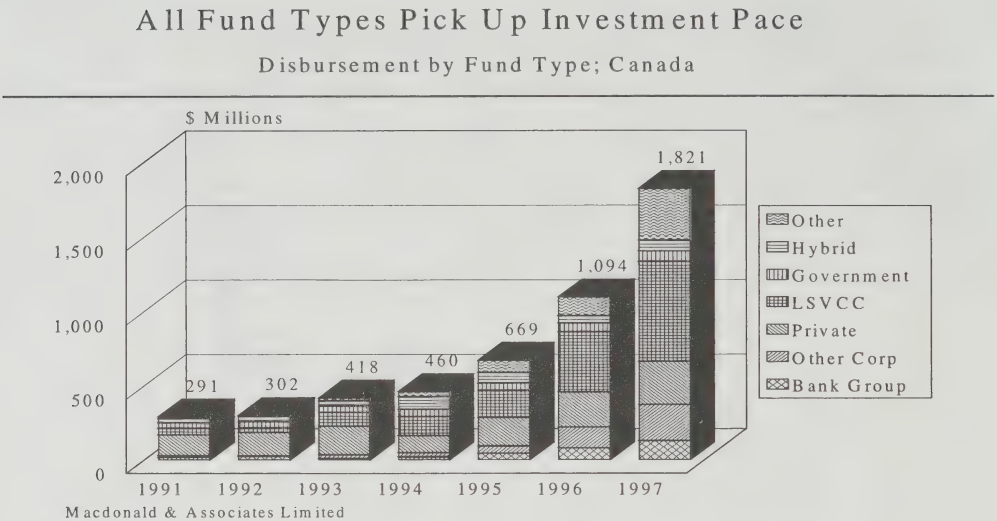
How Much is Being Invested?

The demand for venture capital in Canada has been growing at a rate that matches or exceeds the growth in the supply of capital. In 1991, the industry as a whole invested $291 million. After ramping up gradually in the following years, the pace of growth picked up sharply, reaching $669 million in 1995, $1.1 billion in 1996 and $1.8 billion in 1997. There are, in our view, three key factors contributing to this growth. First, the number of entrepreneurs in Canada experienced in managing high growth companies has increased sharply in recent years as we have built a strong and dynamic software industry, a growing presence in the life science sector and a growing world presence in technology overall. Second, the number of experienced and knowledgeable venture capital investors has also grown, dramatically increasing their ability to bring “knowledgeable” capital to the table. And third, the supply of risk capital has grown significantly in recent years, which is a prerequisite if entrepreneurs are to take on the business, technology and market risks associated with growing a successful company.

All types of venture funds have been contributing to this growth in investment activity (see Chart 5). Bank-owned venture groups, which were investing $10 million - $20 million a year in the early 1990s, collectively invested $129 million in 1997. While most other types of fund split their investments fairly evenly between new and follow-on transactions, almost 70% of the capital invested by bank groups went to first time financings. Other corporate-owned groups flowed an additional $244 million, giving corporate funds a 20% share of total activity compared to their 10% share of a radically smaller market in 1991.

Chart 5



LSVCCs have also ramped up their investment activity to reflect their growth in resources, investing a total of $671 million last year, compared with $404 million one year earlier and only $46 million back in 1991. Private independent funds have experienced more moderate growth in their investment activity in recent years, primarily because the amount of new capital they raised did not increase significantly until last year. These funds will likely experience stronger growth in their disbursements this year as a result.

Finally, it should be noted that all members of the industry have started to effectively tap "other" outside investors to coinvest with them in their deals. As a result, these other investors accounted for disbursements of $346 million last year or 19% industry activity.

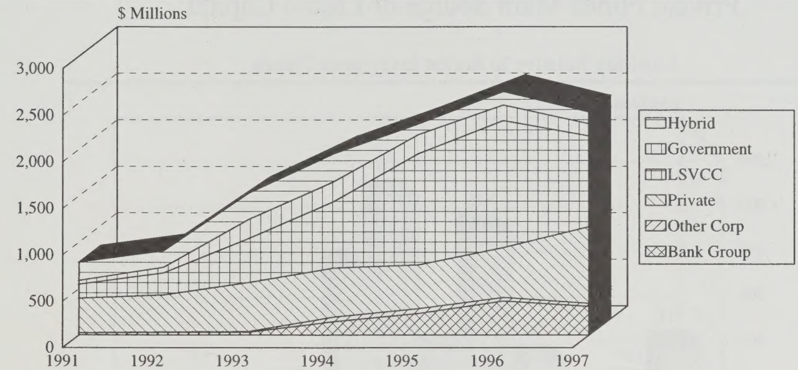
Can the Pace be Sustained?

After building a liquidity cushion through the mid-1990s that was well in excess of the market demand, the sharp uptick in investment activity in the past two year raises questions as to whether the industry can sustain this investment pace. In fact, net liquidity declined in 1997 for the first time this decade (see Chart 6).

Chart 6

Net Liquidity Declines in 1997

Capital Available fot Investment by Fund Type; Canada



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One of the key variables driving liquidity in the near term at least, is the future of the LSVCCs. While fairly stable in BC, Quebec and Manitoba, the future of the LSVCCs in Ontario is very uncertain. At the national level, these funds accounted for just less than half of the industry's liquidity. However, some of the larger Ontario funds, which have not raised much, if any new capital in recent years, are starting to face some significant redemptions, which will inevitably reduce their ability to make new investments unless they raise more new capital. The Ontario-based LSVCCs have less liquid capital among themselves than they collectively invested last year, suggesting they will not be available to sustain the investment pace they set last year. At the national level, the LSVCCs have about a 1.5 year supply of capital still available.

We would expect the bank groups to continue to invest aggressively and to augment their capital commitments as and when required. Existing liquidity represents about a 2.5 year supply, based on last year's disbursements, although the bank groups are likely to continue to pick up their investment pace. The private independent funds experienced an increase in their liquidity in 1997 for the first time in several years, enhancing their ability to be more active investors in the market for the foreseeable future.

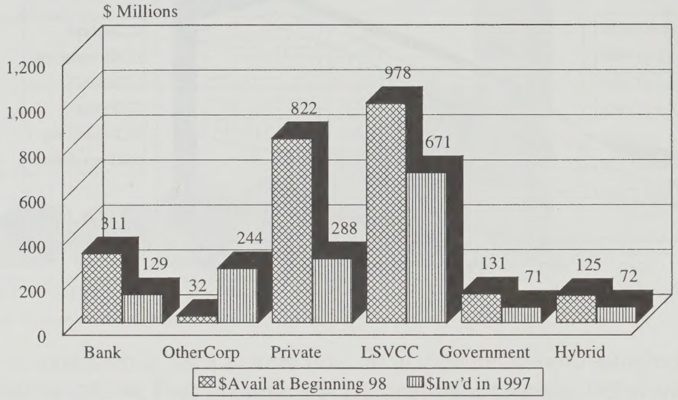
In 1995, the industry's liquidity at the national level represented almost a four year supply of capital. At the beginning of this year, the $2.4 billion of liquid capital represented only slightly more than a one year's supply. There is little reason to assume that the demand for venture capital will alter significantly in the foreseeable future. While the pressure on some of the LSVCC s to deploy their capital may have put some upward pressure on disbursements, we believe that if this was the case, its impact would only have been at the margin. But as the economy continues to grow and emerging growth firms continue to thrive, the demand for

venture capital will continue to grow. This rapid growth in demand clearly creates some supply side pressures for the industry going forward.

Chart 7

Private Funds Main Source of Liquid Capital

Liquidity Relative to Recent Investment Trends



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The ability of the industry to deal with these pressures will, in our view, be determined to some extent by the ability of private independent funds to continue to augment their resources and continue to occupy a strong position in the market. Whether they will be able to do this will be significantly influenced by the willingness of institutional investors to commit more capital to this asset class. While their are a handful of pension funds that are actively pursuing venture capital investments at present, the vast majority are still sitting on the sidelines. Whether the practical and attitudinal hurdles they face in becoming more active in the market can be overcome remains to be seen.